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No. 80-1745

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

F. W. WOOLWORTH CO., *Appellant,*

v.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, *Appellee.*

Appeal from the Supreme Court of New Mexico

BRIEF OF APPELLANT

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QUESTIONS PRESENTED

1. Whether, under the "unitary business" test set forth by this Court in *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), New Mexico's inclusion in appellant's apportionable business income of dividends paid to appellant by functionally independent foreign subsidiaries contravenes the Due Process Clause of the Fourteenth Amendment to the Constitution of the United States.

2. Whether New Mexico's inclusion in appellant's apportionable business income of a "gross-up" amount equal to the "deemed paid" foreign tax credit allowed by the Federal Government with respect to the foregoing dividends contravenes the Due Process Clause.

3. Alternatively, whether New Mexico's inclusion of the dividends and "gross-up" in appellant's apportionable business income, without a correlative adjustment in the apportionment factors, contravenes the Due Process Clause.

4. Alternatively, whether New Mexico's inclusion of the dividends and "gross-up" in appellant's apportionable business income, without a correlative adjustment in the apportionment factors, contravenes the Foreign Commerce Clause of Article I, Section 8 of the Constitution.

SUBSIDIARIES (OTHER THAN WHOLLY OWNED SUBSIDIARIES) AND AFFILIATES OF F. W. WOOLWORTH CO., APPELLANT[1]

F. W. Woolworth public limited company (English subsidiary)[2]

F. W. Woolworth Co., S.A. de C.V. (Mexican affiliate)[3]

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[1] This list is provided pursuant to Rule 28.1 of the Rules of this Court.

[2] This company is the English subsidiary involved in this appeal. Its name was changed in 1981 from F. W. Woolworth and Co., Limited to the present name.

[3] This company is the Mexican corporation involved in this appeal. During the taxable year at issue it was wholly owned, but 51% of its stock was sold to Mexican nationals in 1981.

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Appeal from the Supreme Court of New Mexico

BRIEF OF APPELLANT

OPINIONS BELOW

The opinion of the Supreme Court of the State of New Mexico (the "New Mexico Supreme Court") is reported as *Taxation & Revenue Dept., etc.* v. *F. W. Woolworth,* 95 N.M. 519, 624 P.2d 28 (1981). The opinion of the Court of Appeals of New Mexico (the "New Mexico Court of Appeals") is reported as *F. W. Woolworth* v. *Bureau of Revenue of N.M.,* 95 N.M. 542, 624 P.2d 51 (Ct.App. 1979). Included as Appendix A to the Jurisdictional Statement[1]

[1] The Jurisdictional Statement filed in this case contains seven appendices, herein referred to as "J.S.App.A" through "J.S. App.G." The pages in the seven appendices are consecutively numbered. Where appropriate, references to these appendices will be followed by a page number indicating the location of the cited material in the appendices as a whole.

The separately bound joint appendix filed by the parties to this appeal will be referred to as the "J.A."

The four appendices attached to this brief will be referred to as "App.A, *infra*" through "App.D, *infra.*"

are copies of those opinions (J.S.App.A 1a-22a and 23a-29a, respectively) and the unreported Decision and Order of the Director of the Revenue Division of the Taxation and Revenue Department of the State of New Mexico (referred to herein as the "Revenue Department" or appellee) (J.S.App.A 30a-38a).

JURISDICTION

On January 19, 1981, the New Mexico Supreme Court rendered its opinion upholding the constitutionality of the New Mexico taxing statute as applied to appellant. This appeal was docketed within 90 days of that date on April 17, 1981. This Court noted probable jurisdiction on October 5, 1981. (J.A. 71a) This Court has jurisdiction under 28 U.S.C. § 1257(2).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Commerce Clause (Art. I, § 8, cl. 3):

> Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes;

Due Process Clause (Amend. XIV, § 1):

> [N]or shall any State deprive any person of life, liberty, or property, without due process of law;

Sections 7-2-2(S), 7-2-2(T), 7-4-2(A), 7-4-3, 7-4-5, 7-4-8, 7-4-10, and 7-4-11 of the New Mexico Statutes 1978, Annotated ("N.M.S.A. 1978") are set forth in J.S.App.D.[2]

Sections 212(2) and 215(1) of the Income Tax Act of Canada; EStG Articles 20(1) No. 1, 43(1) No. 1, 44(1),

[2] The statutory references are to the New Mexico statute as recodified in 1978 since these are the statutory provisions referred to in the opinion of the New Mexico Supreme Court. The substantive provisions, however, are the same as those in effect during the period in issue and were not amended or changed as part of the recodification.

49(1) No. 5; and KStG Article 50(2) No. 2 of Germany; and Articles 60 V, 61, 73 I, and 74 of the Income Tax Law of Mexico, as in effect during the year in issue, are set forth in App. A, *infra*.

Sections 78, 901(a), and 902(a) of the Internal Revenue Code of 1954, as amended, are set forth in App. B, *infra*.

STATEMENT OF THE CASE

F. W. Woolworth Co., the appellant, is a New York corporation engaged in the retail business throughout the United States, Puerto Rico, and the Virgin Islands. It purchases a variety of consumer items (including dry goods, hardware, appliances, candy, and some packaged food) and sells them at retail through Woolworth and Woolco stores. Most of the stores also serve fountain items and meals. (J.S.App.A 2a, 32a) The foregoing business activities are hereinafter referred to as appellant's "Unitary Business."

During its fiscal year in issue, which ended January 31, 1977 ("fiscal 1977"), appellant received $39,881,161 in dividends from four of its foreign subsidiaries: F. W. Woolworth and Co., Limited, a 52.7% owned English subsidiary; F. W. Woolworth Co. GmbH, a wholly owned German subsidiary; F. W. Woolworth, Limited, a wholly owned Canadian subsidiary; and F. W. Woolworth Co., S.A. de C.V., a wholly owned Mexican subsidiary. (J.S. App.A 1a, 26a, 33a, 35a; J.A. 61a, Sch. C, line 5)

During fiscal 1977, these four subsidiaries were in the same general type of business as appellant, operating retail stores in their respective countries. (J.S.App.A 33a) The operation of a multi-store retail business, such as that carried on by each of appellant's foreign subsidiaries, entails the following essential functions: selecting sites for stores, selecting the type and quantity of merchandise to be sold to the public, inventory purchasing, advertising, funding of business operations, accounting and cash control, and personnel selection and training. (J.A. 10a-11a)

Appellant's foreign subsidiaries did no business in New Mexico or elsewhere in the United States. In addition, as the record shows, each subsidiary's retail business was functionally separate and distinct from appellant's retail business in the United States and from the retail businesses conducted by the other foreign subsidiaries.[3] Each subsidiary made and carried out its own decisions with respect to:

1. *Site selection:* Each subsidiary chose its own store sites, without consulting appellant. (J.A. 11a-12a, 18a, 26a, 30a; J.S.App.A 33a)

2. *Merchandise selection:* Each subsidiary sold a different mix of merchandise in order to respond to local tastes and needs in its own country. For example, in England, many of the stores had a restaurant and cafeteria as well as a supermarket section where food was sold. In Germany, there was an emphasis on soft goods (such as dresses, coats, and other clothing) and there were no food selling operations. (J.A. 12a-13a, 18a, 21a; J.S.App.A 33a)

3. *Inventory purchasing:* Each subsidiary purchased its inventory separately and there was no central buying office. Although the New Mexico Supreme Court stated otherwise, the record shows that there were no intercompany sales of inventory between appellant and the foreign subsidiaries. In large part, each subsidiary made its inventory purchases in its own country. However, even where appellant and its foreign subsidiaries purchased inventory items in the same countries abroad (*e.g.*, the Orient), the purchasing was done independently. (J.A. 13a-14a, 18a, 25a, 29a, 42a-45a; J.S.App. A 33a-34a)

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[3] The factual statements which follow are based on the testimony (J.A. 9a-54a) and on the findings of the Revenue Department's Hearing Examiner (J.S.App.A 30a-36a). In describing the evidence cited by appellee, the New Mexico Supreme Court made several factual statements (J.S.App.A 8a-9a) which are not supported by the record. These statements are identified and discussed at pp. 21-24, *infra*.

4. *Advertising:* Each foreign subsidiary handled its own advertising. There was very little advertising in Germany, whereas there was a very high degree of local advertising in England. (J.A. 12a, 13a, 14a-15a, 18a, 29a; J.S.App.A 34a)

5. *Funding of business operations:* Each subsidiary was responsible for funding its day-to-day business operations, although major financial decisions were approved by appellant. During the year in issue and for some time prior thereto, appellant provided no financial support to the subsidiaries except that some of the dividends which the German subsidiary declared to reduce its own German taxes were reinvested in the German subsidiary. (J.A. 16a-18a, 26a, 28a, 29a, 30a-33a, 45a-46a, 51a-52a; J.S.App.A 27a-28a, 35a)

6. *Accounting and cash control:* Each subsidiary handled these functions autonomously. Each had a complete accounting department and financial staff. (J.A. 12a, 14a, 18a; J.S.App.A 34a)

7. *Personnel selection and training:* Appellant did not have a personnel training school for its foreign subsidiaries. Nor did appellant rotate or exchange personnel with its subsidiaries. Each subsidiary developed its own managers. The Chief Executive Officers of the English and German subsidiaries were local nationals. In fact, none of the officers of those subsidiaries was a current or former employee of appellant. (J.A. 13a, 15a-16a, 18a, 24a-25a, 50a; J.S. App.A 34a)

Several of appellant's 15 to 18 Directors served on the Board of Directors of the Canadian, English, or Mexican subsidiaries. (J.A. 23a-24a, 29a, 39a, 40a-41a; J.S.App.A 34a) The Chief Executive Officers of the subsidiaries came to New York "on a rare occasion, once a year," and appellant's Chief Executive Officer traveled to Canada, England, or Germany "on occasion." (J.A. 34a-35a; J.S.App.A 34a) Other officers of appellant may have traveled there sporadically. (J.A. 35a) Appellant had a vice president who performed a liaison function with the smaller foreign subsidiaries in Mexico and Spain and may have contacted the other foreign subsidiaries from time to time. (J.A. 50a;

J.S.App.A 34a) In addition, there was communication of an unspecified nature by telephone, correspondence, and teletype. (J.A. 34a-35a; J.S.App.A 34a) However, there was no ongoing day-to-day communication or exchange of information at the operating level concerning market conditions, pricing of merchandise, or other operational matters. (J.A. 36a-37a) The managers of the subsidiaries never got together to discuss overall operations, planning for future programs, or future expansion. (J.A. 35a) Nor did appellant have a department or section devoted to overseeing the operations of the foreign subsidiaries. (J.A. 50a; J.S.App.A 34a)

In fiscal 1977, appellant realized an exchange gain of $1,595,551 from a hedging transaction in British pounds. Appellant entered into this transaction in order to protect the dollar value of a declared dividend which appellant expected to receive from its English subsidiary in British pounds. (J.A. 52a-54a, 57a, line 17)

On its federal income tax return for fiscal 1977, appellant elected, pursuant to sections 901(a) and 902(a) of the Internal Revenue Code (the "Code"), to claim "deemed paid" foreign tax credits for foreign taxes actually paid by the foreign subsidiaries with respect to the earnings they distributed as dividends to appellant. Under section 78 of the Code, appellant was required to treat the $25,502,782 amount of such deemed paid credits as "grossed-up" dividend income.[4] (J.A. 61a, Sch. C, line 7; J.A. 63a, line 10(a))

In filing its New Mexico tax return for fiscal 1977, appellant apportioned its operating business income between

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[4] Sections 901(a), 902(a), and 78 of the Code are set forth in App. B, *infra*. If a foreign subsidiary of a United States parent earns $100, pays foreign tax of $40, and pays a dividend of $30 out of its after-tax profits of $60, the deemed paid foreign tax credit of the parent under section 902(a) is 30/60 × $40, or $20. The parent includes $50 in dividend income (*i.e.*, the actual dividend of $30 plus $20 of "gross-up") and claims a foreign tax credit of $20 against the federal income tax on this income.

sources within and without New Mexico on the basis of the three-factor formula prescribed by section 7-4-10, N.M.S.A. 1978. This three-factor formula apportioned to New Mexico that fraction of appellant's total "business income" which was the average of the ratios of appellant's tangible property, payroll, and sales in New Mexico to its total tangible property, payroll, and sales everywhere. (See J.S.App.D 46a) Appellant did not include its dividends from its foreign subsidiaries, the related "gross-up" amount, or its exchange gain in its apportionable business income. Appellant's apportionable business income and New Mexico taxable income for fiscal 1977 were reported as $18,274,068 and $84,622, respectively. (J.A. 57a)

On audit, the Revenue Department determined that (1) all of appellant's dividends, gross-up, and foreign exchange gain were includable in apportionable business income, and (2) the inclusion of these items in apportionable business income did not warrant any correlative adjustment in appellant's New Mexico apportionment factors to reflect the property, payroll, and sales of the subsidiaries paying the dividends.[5] Because of the large amounts involved, this adjustment increased appellant's New Mexico taxable income from $84,622 to $401,518 for fiscal 1977. (J.A. 69a)

Relying on both statutory and constitutional grounds, appellant challenged the inclusion of the dividends, gross-up, and foreign exchange gain in apportionable business income. Alternatively, appellant challenged the absence of correlative factor modification. The New Mexico Court of Appeals upheld appellant's primary statutory arguments concerning the measure of apportionable business income (thereby reversing the decision of the Revenue Department) without reaching the constitutional issues. (J.S. App.A 23a-29a) This decision, in turn, was reversed by the

[5] The Revenue Department did add the additional income to the denominator of the sales factor, thereby reducing the apportionment percentage from .463073 of 1% (J.A. 57a) to .458335 of 1% (J.A. 69a).

New Mexico Supreme Court which rejected appellant's statutory and constitutional arguments. (J.S.App.A 1a-22a)

SUMMARY OF ARGUMENT

1. *Exclusion of Dividends from Apportionable Income:* Prior decisions of this Court permit a nondomiciliary State to use a formulary apportionment method to determine the income tax liability of a corporation doing business both inside and outside the State. However, this approach is permissible only if and to the extent that the income being apportioned is derived from a "unitary business" in which the activities being conducted outside the taxing State are functionally integrated with the activities being conducted inside the State.

In such cases, the State is permitted to tax a fairly determined fractional part of the total income earned by the enterprise as a whole, because there may be no other way of identifying and separately accounting for the profits generated by the activities within the taxing State. However, where there are operations outside the taxing State which are functionally discrete, and can therefore be separately accounted for, apportionment with respect to those operations is neither necessary nor appropriate. If the out-of-state activities do not contribute in some meaningful way to the production of income within the State, the State has no legitimate interest in taxing *any* portion of the income earned from those out-of-state activities.

In *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), the Court made it clear that the foregoing "functional integration" test applies to dividends which a corporation doing business within the State receives from other corporations operating exclusively outside the State. Under *Mobil*, the dividends may be included in the apportionable income of the recipient only if the out-of-state activities of the payor are so closely related, in a functional sense, to the in-state activities of the recipient that all of those activities constitute a single "unitary business."

In the present case, the dividends which appellant received from its subsidiaries operating retail businesses abroad were not properly includable in appellant's apportionable income for New Mexico tax purposes because all four subsidiaries were independently managed, separately operated, free-standing concerns. Each foreign subsidiary selected its own store sites, determined its own merchandising policies, purchased its own inventory, did its own advertising, handled its own accounting and cash control, and selected and trained its own personnel. By reason of significant geographical and cultural differences, the merchandising operations in each foreign country were necessarily different and distinct. Although the New Mexico Supreme Court stated that there was "some flow back and forth of goods," the record shows that, in actual fact, there were *no* intercompany sales of inventory between appellant and any of the subsidiaries. The Chief Executive Officers of the major subsidiaries were local nationals. Indeed, none of the officers of the two major subsidiaries in England and Germany had *ever* been an officer, *or even an employee,* of appellant.

Thus, in all respects, the retail operations of the foreign subsidiaries were totally separate and distinct from appellant's retail operations in the United States. The profits earned by the foreign subsidiaries and distributed to appellant had nothing to do with appellant's New Mexico activities and should therefore not be included in the New Mexico tax calculation. Appellant's exchange gain from hedging one of the dividends stands on the same footing.

2. *Exclusion of Gross-Up from Apportionable Income:* For federal income tax purposes, appellant claimed a "deemed paid" foreign tax credit for foreign taxes paid by the subsidiaries with respect to the profits they distributed to appellant as dividends. As a mechanical means of arriving at the appropriate overall tax rate in such cases, federal law provides that an amount equal to the deemed paid foreign taxes being credited must be "treated" as additional "gross-up" income of the shareholder claiming

the credit. Thus, gross-up is not income in any conventional sense, but is, instead, an admittedly "fictional" item which is used to *reduce* the tax benefit that a federal taxpayer can derive from claiming a deemed paid foreign tax credit. The inclusion of gross-up in apportionable income at the state level, without any recognition of the larger offsetting foreign tax credit that creates the gross-up under federal law, inevitably contravenes the Due Process Clause. There is no reason or justification for New Mexico to tax *any* portion of a computational item on appellant's federal tax return where, as here, that item is admittedly "fictional" and has absolutely nothing to do with appellant's operations in New Mexico.

3. *Modification of Apportionment Factors:* If this Court nevertheless holds that any or all of the foregoing dividends, exchange gain, and gross-up amounts may constitutionally be included in appellant's apportionable business income, the New Mexico tax will still contravene the Due Process Clause, and also the Foreign Commerce Clause, unless New Mexico adjusts its regular apportionment formula to reflect the foreign property, payroll, and sales which generated the profits being included in appellant's apportionable business income base.

In *Mobil*, this Court held that the apportionability of income the taxpayer receives from unitary business activities should not be affected by whether the income is received in the form of divisional profits or dividends from legally separate entities. This Court stated (445 U.S. at 441) that transforming divisional profits into dividends "works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives."

If the income which appellant received in the form of dividends from subsidiaries operating outside New Mexico had constituted profits of unitary divisions being operated outside New Mexico, there is no question that the out-of-state property, payroll, and sales of the divisions would have been taken into account in the apportionment factors.

New Mexico's failure to reduce the apportionment fraction to reflect out-of-state property, payroll, and sales of the dividend-paying subsidiaries violates the Due Process Clause because it inevitably overstates the portion of appellant's total income which is attributable to its New Mexico property, payroll, and sales.

New Mexico's failure to adjust the apportionment factors also violates the Foreign Commerce Clause by permitting New Mexico to impose a direct tax on foreign-source investment income that has already been taxed abroad. In accordance with international custom, the laws and treaties of this Nation explicitly provide for the avoidance of such double taxation at the federal level. Consequently, New Mexico's failure to use some mechanism that will avoid double taxation at the state level prevents this Nation from speaking with one voice in matters affecting commercial relations with foreign countries.

ARGUMENT

I. UNDER *MOBIL*, NEW MEXICO'S INCLUSION OF THE DIVIDENDS AND RELATED EXCHANGE GAIN IN APPELLANT'S APPORTIONABLE BUSINESS INCOME CONTRAVENES THE DUE PROCESS CLAUSE.

As described above, appellant's "Unitary Business" involves the operation of retail stores throughout the United States, Puerto Rico, and the Virgin Islands. Because it operates retail stores in New Mexico, appellant agrees that it is subject to tax in New Mexico on that portion of the income from its Unitary Business which is properly attributable to its New Mexico activities. Appellant also agrees that New Mexico may use a formulary apportionment method (rather than separate accounting) to determine the portion of appellant's Unitary Business income which is properly attributable to its New Mexico activities. *Exxon Corp.* v. *Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980); *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) (hereinafter "*Mobil*"); *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267 (1978). However, appellant submits that, under the Due Process Clause, the dividends and

related exchange gain at issue here may not be included in the Unitary Business income which is subject to apportionment.

A. This Court's Decision in *Mobil*.

The threshold issue in *Mobil* was whether, under the Due Process Clause, a nondomiciliary State (Vermont) could constitutionally tax (by inclusion in apportionable income) certain dividends received by a resident corporation (Mobil) from nonresident payor corporations having no contact with the taxing State.[6] Although the record in the *Mobil* case failed to provide much detail, this Court made the key finding that (445 U.S. at 435):

> [I]t is apparent, from perusal of such documents in the record as appellant's corporate reports for the years in question, that many of these subsidiaries and affiliates, including the principal contributors to appellant's dividend income, engage in business activities that form part of Mobil's integrated petroleum enterprise. Indeed, although appellant is unwilling to concede the legal conclusion that these activities form part of a "unitary business," see Reply Brief for Appellant 2, n.1, it has offered no evidence that would undermine the conclusion that most, if not all, of its subsidiaries and affiliates contribute to appellant's worldwide petroleum enterprise.

On this basis, this Court upheld Vermont's power to include the dividends paid by these subsidiaries and affiliates in Mobil's apportionable income, stating (445 U.S. at 439):

> [T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle. In

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[6] As used hereinafter, the term "resident" corporation means a corporation which is doing business within the taxing State, but is organized under the laws of some other State and has its headquarters or commercial domicile in some other State. Since appellant has its legal and commercial domicile in New York (J.S.App. A 2a, 30a) and does business in New Mexico, appellant is a resident of New Mexico.

accord with this principle, what appellant must show, in order to establish that its dividend income is not subject to an apportioned tax in Vermont, is that the income was earned in the course of activities unrelated to the sale of petroleum products in that State. *Bass, Ratcliff & Gretton* [266 U.S. 271 (1924)] forecloses the contention that the foreign source of the dividend income alone suffices for this purpose. Moreover, appellant has made no effort to demonstrate that the foreign operations of its subsidiaries and affiliates are distinct in any business or economic sense from its petroleum sales activities in Vermont. Indeed, all indications in the record are to the contrary, since it appears that these foreign activities are part of appellant's integrated petroleum enterprise. [Footnote deleted.]

This Court also stressed that the form of business organization should have no impact on the outcome, stating (445 U.S. at 440-441):

Nor do we find particularly persuasive Mobil's attempt to identify a separate business in its holding company function. So long as dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise, those dividends are income to the parent earned in a unitary business. One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability.

Superficially, intercorporate division might appear to be a more attractive basis for limiting apportionability. But the form of business organization may have nothing to do with the underlying unity or diversity of business enterprise. Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability. Cf. *General Motors Corp.* v. *Washington*, 377 U.S. 436, 441 (1964). Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives. [Footnote deleted.]

In addition, at a later point in the opinion, the Court explicitly confirmed that it had based its decision on the relationship between Mobil's activities and those of the payor corporations, stating (445 U.S. at 442):

> Where the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State, due process considerations might well preclude apportionability, because there would be no underlying unitary business. We need not decide, however, whether Vermont's tax statute would reach extraterritorial values in an instance of that kind. Cf. *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S., at 121. Mobil has failed to sustain its burden of proving any unrelated business activity on the part of its subsidiaries and affiliates that would raise the question of nonapportionability. [Citations and footnote deleted.]

B. Under the "Unitary Business" Test of *Mobil*, the Issue Is Whether the Activities of the Dividend-Paying Corporation and Those of the Recipient in the Taxing State Are Part of a Single Functionally Integrated Business.

The foregoing quotations from the Court's opinion make it plain that the unitary business test adopted in *Mobil* is whether the "underlying activity"—that is, the *business activity of the dividend-paying corporation*—is part of a "functionally integrated enterprise" being conducted, in part, by the recipient corporation in the taxing State. In other words, the test is whether the activities of the dividend-paying corporation and the activities of the recipient in the taxing State are part of the same functionally integrated, unitary business.

The reason for this "functional integration" requirement becomes obvious when one bears in mind the purpose of formulary apportionment. As this Court has recognized on many occasions, the need for formulary apportionment arises in cases such as this because of (1) the constitutional requirement that a nondomiciliary State tax only the income from the resident corporation's in-state activities, and

(2) the difficulty in determining such income where the resident corporation conducts an integrated, unitary business both within and without the taxing State. See, *e.g.*, *Exxon Corp.* v. *Wisconsin Dept. of Revenue, supra* (integrated petroleum business); *Mobil,* (integrated petroleum business); *Moorman Mfg. Co.* v. *Bair, supra* (integrated manufacture and sale of animal feeds); *Butler Bros.* v. *McColgan,* 315 U.S. 501 (1942) (integrated wholesale business); *Bass, Ratcliff & Gretton* v. *State Tax Commission,* 266 U.S. 271 (1924) (integrated manufacture and sale of ale); and *Underwood Typewriter Co.* v. *Chamberlain,* 254 U.S. 113 (1920) (integrated manufacture and sale of typewriters). In such cases, the State is "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." *Underwood Typewriter Co.* v. *Chamberlain, supra,* 254 U.S. at 121. But such allocation is "impossible" only where the in-state and out-of-state activities are so closely tied together that the income is earned by the entire enterprise as a unit; in such cases, as this Court noted in *Mobil* (445 U.S. at 438):

> [S]eparate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. *Butler Bros.* v. *McColgan,* 315 U.S., at 508-509. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source."

By comparison, where two activities of a corporation, or the activities of a parent corporation and its subsidiary, are functionally discrete, separate accounting will suffice to determine the income from each separate activity and there is no need for apportionment.

The foregoing analysis has been uniformly recognized by this Court in its apportionment decisions. For example, in *Adams Express Co.* v. *Ohio State Auditor,* 165 U.S. 194 (1896), the Court noted that unity of ownership alone was

insufficient to justify apportionment, stating (165 U.S. at 222):

> The same party may own a manufacturing establishment in one state and a store in another, and may make profit by operating the two, but the work of each is separate. The value of the factory in itself is not conditioned on that of the store, or *vice versa*, nor is the value of the goods manufactured and sold affected thereby. The connection between the two is merely accidental and growing out of the unity of ownership.

By comparison, where the store sells the products manufactured by the factory, the operations of the two become functionally integrated and apportionment is appropriate. Thus, in *Bass, Ratcliff & Gretton* v. *State Tax Commission, supra*, this Court stated (266 U.S. at 282):

> So in the present case we are of the opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions, beginning with the manufacture in England and ending in sales in New York and other places, —the process of manufacturing resulting in no profits until it ends in sales, —the state was justified in attributing to New York a just proportion of the profits earned by the company from such unitary business.

Similarly, where, as here, a multi-store retail business is involved, apportionment may be appropriate if the operations (merchandise selection, inventory purchasing, advertising, and other similar functions) are conducted in an integrated fashion. In such a case, the integration would be "horizontal" rather than "vertical." See, *e.g., Butler Bros.* v. *McColgan, supra*, where wholesale stores in several States were operated in an integrated fashion by utilizing a central buying division, a central advertising division, and centralized executive management.

Thus, to qualify as a unitary business, the activities involved must constitute a *functionally integrated enterprise which earns its income as a unit or a whole*, thereby justifying apportionment. In accordance with this principle,

many of the cases involving dividend income have recognized that apportionability turns on the functional relationship between the activities of the payor and recipient corporations. In addition to *Mobil*, see also *F. W. Woolworth Co.* v. *State of Alaska, Department of Revenue* (Alaska Sup. Ct. Oct. 29, 1981); *Square D Co.* v. *Kentucky Board of Tax Appeals*, 415 S.W.2d 594 (Ky. 1967); *Gulf Oil Corp.* v. *Clayton*, 267 N.C. 15, 147 S.E.2d 522 (1966); *American Bakeries Co.* v. *Johnson*, 259 N.C. 419, 131 S.E. 2d 1 (1963); and *Marshall-Wells Co.* v. *Commissioner of Taxation*, 220 Minn. 458, 20 N.W.2d 92 (1945).

In the recent Alaska *Woolworth* case, which involved dividends appellant received from its foreign subsidiaries in 1972 through 1975, the Alaska Supreme Court expressly held that, under *Mobil*, the dividends could not be included in appellant's apportionable income unless "the business from which the dividends [were] derived" was "part of the unitary business being taxed. . . ." (Slip Op. 2) The case was remanded for a determination on this issue. Thereafter, the Alaska Department of Revenue filed a petition for rehearing conceding that appellant was "not conducting a unitary business with the foreign sibling corporations from which it received the dividends."

In *Square D Co.* v. *Kentucky Board of Tax Appeals, supra*, a parent corporation doing business in Kentucky received dividends from two wholly owned subsidiaries conducting the same type of business in Canada and Mexico. In recognition of the constitutional limitations on state taxation, the court concluded that the Kentucky statute should be construed to prevent Kentucky from including the dividends in the parent's apportionable income. In so holding, the court stated (415 S.W.2d at 602):

> No part of the . . . Canadian or Mexican incomes can be said to have been derived from Kentucky operations unless the apparently independent foreign activities were so integrated and interrelated with those in Kentucky that the separate sources cannot be reasonably and separately identified. We do not think this can be

> said of any of the dividend . . . income here in controversy.

Over the years, a number of other tests for determining the scope of a unitary business have been formulated by the courts.[7] In the present case, and in a prior New Jersey decision also involving the apportionment of appellant's dividend income, the state courts looked to the overall size and financial power which appellant derived from its ownership of the stock of the subsidiaries. See the decision below (J.S.App.A 18a-19a) and *F. W. Woolworth Co.* v. *Director of Div. of Taxation*, 45 N.J. 466, 213 A.2d 1 (1965).

In the New Jersey case, the court stated (213 A.2d at 14):

> We know of no United States Supreme Court case holding or even intimating that . . . close functional integration [of the type involved in *Butler Bros.* v. *McColgan, supra*] is a *sine qua non* for a finding of a unitary enterprise. . . .

In *Mobil*, this Court stated (445 U.S. at 440) that dividends may be apportioned "[s]o long as . . . [they] reflect profits derived from a functionally integrated enterprise. . . ." Thus, it is obvious that the New Jersey court's decision—and other prior state court decisions like it—no longer have any vitality.

In its Motion to Dismiss, appellee states (pp. 4-5) that we are misreading *Mobil*, and asserts that attention must be focused on appellant's *own* activities to determine whether appellant's income-producing investments are sufficiently related to appellant's other business activities to form part of its Unitary Business. There may be situations, not considered in *Mobil* and not present here, in which it

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[7] See, *e.g.*, the cases discussed in Keesling and Warren, *The Unitary Concept in the Allocation of Income*, 12 Hastings L.J. 42, 45-52 (1960) and Hellerstein, *Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business*, 21 Nat.Tax.J. 487, 496-501 (1968). See also *Mobil*, 445 U.S. at 439, n.14 and 443, n.17.

would be appropriate to focus only on the taxpayer's own activities, without regard to the underlying activities of the company paying the dividends.[8] But where, as here, there is no evidence suggesting that the taxpayer's business consists of, or necessarily involves, securities investments, there is no basis under *Mobil* for treating the dividend income as part of the taxpayer's unitary business income unless the underlying business activities generating that income are functionally integrated with the taxpayer's business activities. As we shall now show, that type of functional relationship does not exist in the present case.

C. Application of the *Mobil* "Functional Integration" Test to This Case.

Appellant has met its burden under *Mobil* by showing that the retail businesses of its foreign subsidiaries were functionally separate and distinct from appellant's own retail business activities in New Mexico and elsewhere in the United States. As described in greater detail in our statement of the case (pp. 4-6, *supra*), each subsidiary made and carried out its own decisions with respect to all of its essential operating functions (site selection of the stores, merchandise selection, inventory purchasing, advertising, funding of business operations, accounting and cash control, and personnel selection and training). None of these functions was centrally managed by appellant. Nor did any of the foreign subsidiaries conduct these functions in an integrated fashion with appellant or any of the other subsidiaries. (J.A. 12a-15a, 18a, 25a, 29a-30a, 35a, 48a)

As a consequence of operating its own separate retail business, each subsidiary conducted its business in a somewhat different manner, selling different merchandise, using different types of advertising, and using different person-

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[8] For example, if the taxpayer is a securities dealer or underwriter, it may be constitutionally permissible for a State to treat the taxpayer's dividend and interest income from securities held in inventory as apportionable business income.

nel. (J.S.App.A 33a-34a; J.A. 12a-15a, 18a, 21a) Each subsidiary also purchased its own inventory separately, generally in its own country. And even where appellant and its foreign subsidiaries purchased inventory items in the same countries, the purchasing by each corporation was done independently. (J.S.App.A 33a-34a; J.A. 13a-14a, 18a, 25a, 44a)

The facts here are in obvious contrast to the situation in *Butler Bros.* v. *McColgan, supra,* which involved "closely integrated" wholesale operations with a "central buying division," a "central advertising division," and "centralized management." See 315 U.S. at 504-505, 508-509. Under those circumstances, where the benefit of centralized functions contributed to the profitability of the business as a whole, this Court held that apportionment was a permissible method for determining the taxpayer's California taxable income. See also *Edison California Stores* v. *McColgan,* 30 Cal.2d 472, 183 P.2d 16, 18 (1947), where a multi-store retail operation conducted by an affiliated group of corporations was treated as a single, unitary business because all of the corporations used "[a] central management division, a central purchasing department, a central distributing department, a central store operations department, a central advertising department, and various other central administrative departments."

Here, however, as shown above, appellant and its foreign subsidiaries carried on their retail businesses separately and independently. The foreign operations had no functional connection with, and therefore contributed nothing to the efficiency or profitability of, appellant's Unitary Business, which was purely domestic. Appellant's English subsidiary earned all of its profits in England. Nothing that it did had any effect on the profitability of appellant's stores in New Mexico. The same was true of each of the other foreign subsidiaries. Therefore, there is no need or reason to take the income generated by the subsidiaries' foreign operations into account in determining the income attributable to appellant's New Mexico activities. The

profits earned by appellant's domestic Unitary Business and the profits earned by the subsidiaries' operations abroad can be accurately determined on a separate accounting basis because there were *no* intercompany sales of inventory or other business transactions between appellant and the subsidiaries, and no shared services, facilities, or activities which would make it difficult to determine the income of each corporation on a separate basis. Accordingly, there is no constitutional justification for including any part of the profits earned by the foreign operations in the New Mexico tax calculation.

In reaching the opposite conclusion, the New Mexico Supreme Court misstated several significant facts and relied on other factors which are not relevant. The principal erroneous or potentially misleading statements in the court's opinion are the following:

1. *Flow of goods:* In describing the evidence on which appellee was relying, the court stated that "There is some flow back and forth of goods. . . ." (J.S.App.A 9a) This statement is contrary to the record. On direct examination, appellant's witness, Mr. Feeley, was asked, "Are there any inter-company sales of inventory?" and he answered, "None." (J.A. 13a) On cross-examination, when asked whether the English subsidiary purchased goods from appellant, he confirmed that "They do not. . . ." (J.A. 44a) There is no other record reference to any intercompany inventory transactions involving appellant and the foreign subsidiaries.[9] Accordingly, the uncontradicted evidence of

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[9] When asked on cross-examination whether the foreign subsidiaries purchased any merchandise from three manufacturing subsidiaries of appellant, the witness responded, "I don't know . . . . It is inconceivable to me . . . that they would." (J.A. 43a; see also J.A. 42a) This is perfectly consistent with his unqualified statement on direct examination that there were no "inter-company sales of inventory." (J.A. 13a) That statement clearly related, in context, to possible intercompany sales involving appellant. (See J.A. 12a-14a.)

record shows that there was *no* "flow of goods" between appellant and the subsidiaries.

2. *Exchange of business information:* The New Mexico Supreme Court's recitation of the evidence states that "[t]here is a substantial exchange of business information . . . between the parent and its affiliates." (J.S.App.A 9a) In fact, despite the efforts of counsel for appellee to develop evidence which would have supported such a statement (J.A. 33a-37a), the record shows that:

a. The managers of the subsidiaries never got together to discuss overall operations, planning for future programs, or future expansion. (J.A. 35a)

b. Although appellant's personnel and the subsidiaries' personnel exchanged information "from time to time" (J.A. 36a), there was no ongoing day-to-day dialogue or exchange of information at the operating level concerning "purchasing, accounting, planning, advertising, merchandising, expansion or retraction from markets, personnel training, site selection." (J.A. 36a-37a)[10]

c. The chief executives of the foreign subsidiaries came to New York "on a rare occasion, once a year." (J.A. 34a)

d. Appellant's "Chief Executive Officer would on occasion travel to Canada, England, or to Germany to confer with the managers there." (J.A. 35a)

e. The "methods of communication" between appellant and the foreign subsidiaries included the telephone, correspondence, and teletype, but there was no testimony as to

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[10] After specifically asking whether there was a "definite exchange of information" with respect to these activities "in all levels" and receiving a response which was clearly going to be negative (J.A. 36a-37a), counsel for appellee interrupted, stating (J.A. 37a):

> Q. I see. It is not a day-to-day type of thing and he isn't telling them what to sell a given item for, I didn't mean that at all.
>
> I am talking about the bigger picture—the big picture I am talking about.

the frequency of their use or the nature of any communications. (J.A. 34a-35a)

Obviously there was some communication between appellant and its foreign subsidiaries. However, the New Mexico Supreme Court's statement that there was a "substantial exchange of business information" (J.S.App.A 9a) goes beyond the record and is misleading. The limited communications that emerge from the record afford no basis whatever for concluding that the subsidiaries' activities in their respective foreign countries were a "functionally integrated" part of appellant's Unitary Business activities.

3. *Flow of financial resources:* The New Mexico Supreme Court's recitation of the evidence states there was "some flow back and forth of . . . financial resources." (J.S.App.A 9a) This statement is not erroneous if it is only intended to refer to appellant's initial investment in the foreign subsidiaries, the relatively small loans which were made by appellant to the subsidiaries and repaid well before the year in issue, the reinvestments in the German subsidiary of dividends which were declared to reduce the German subsidiary's own taxes, and the dividends paid by the subsidiaries to appellant. (See J.A. 16a-18a, 28a, 30a-31a, 32a-33a, 45a-46a, 51a-52a) Such a "flow" of "financial resources" is perfectly consistent with any investment by a major shareholder in a corporation and is therefore irrelevant in determining whether the business activities of the shareholder and the corporation are functionally integrated.[11]

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[11] The New Mexico Supreme Court also stated that the dividends were placed in appellant's "general operating account" (J.S.App. A 19a), and emphasized this as pointing to functional integration. This argument proves too much. If it were correct, then all investment income could be included in apportionable business income and the discussion in *Mobil* of the "underlying activities" of the dividend-paying corporation would be meaningless. Moreover, even if use of the funds were relevant, the result here would not change. The record does not support the Hearing Examiner's finding that

However, considered by itself, the court's statement regarding a "flow" of financial "resources" might be more broadly construed, and it could therefore be misleading unless clarified as above.

4. *Oversight of the foreign subsidiaries:* The New Mexico Supreme Court's recitation of the evidence also states that appellant "has an international vice president that is responsible for overseeing its foreign subsidiaries. . . ." (J.S. App.A 8a) In fact, as found by the Hearing Examiner (J.S.App.A 34a), the vice president was only a "liaison man with the smaller foreign subsidiaries." This finding is based directly on the testimony. (J.A. 50a) The Hearing Examiner also found (J.S.App.A 34a) that "[t]he taxpayer has no department or section, as such, devoted to overseeing the foreign subsidiary operations." Insofar as the issue of control is concerned, appellant's activities were limited to the normal stewardship functions of a major corporate shareholder (*e.g.*, approval of major financial decisions, interlocking directors with some of the subsidiaries' Boards of Directors, and control over dividend payments).

In view of the foregoing, there can be no real dispute about the functional independence of appellant's foreign subsidiaries. Admittedly, appellant owned a controlling interest in each subsidiary and the subsidiaries were engaged in the same type of business as appellant. But in themselves, these factors do not establish the requisite functional integration and, therefore, they are insufficient to justify the apportionment of the dividends. *F. W. Woolworth Co.* v. *State of Alaska, Department of Revenue,*

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the dividends were (J.A.App.A 35a) "used for general corporate operating purposes." The testimony only showed that the dividends were placed in appellant's "general treasury." (J.A. 52a) Thus, the New Mexico Court of Appeals stated that it was more reasonable to regard the dividends of $39,881,161 as simply being passed on to appellant's shareholders, who received $39,986,308 in fiscal 1977. (J.S.App.A 27a; J.A. 61a, Sch. C, line 5; J.A. 65a, Sch. M-2, line 5)

supra; Square D Co. v. *Kentucky Board of Tax Appeals, supra; Gulf Oil Corp.* v. *Clayton, supra; American Bakeries Co.* v. *Johnson, supra.* See also *Adams Express Co.* v. *Ohio State Auditor, supra.*

In *Mobil,* this Court held (445 U.S. at 442, 435) that Mobil "failed to sustain its burden of proving any unrelated business activity on the part of its subsidiaries and affiliates" because it "offered no evidence" to rebut the conclusion that the dividend-paying subsidiaries and affiliates contributed to its "worldwide petroleum enterprise." Here, appellant has met its burden under *Mobil* by showing that the "business activities of the dividend payor[s] have nothing to do with the activities of . . . [appellant] in the taxing State. . . ." (445 U.S. at 442) Appellant's New Mexico income can be fairly and adequately determined by apportioning the income from appellant's own domestic Unitary Business without taking into account the dividends from the foreign subsidiaries.[12]

II. NEW MEXICO'S INCLUSION OF THE SECTION 78 GROSS-UP AMOUNT IN APPELLANT'S APPORTIONABLE BUSINESS INCOME ALSO CONTRAVENES THE DUE PROCESS CLAUSE.

On its federal income tax return for fiscal 1977, appellant elected under section 901(a) of the Code (App. B, *infra*) to claim credits rather than deductions for foreign tax payments. Under section 902(a) of the Code (App. B, *infra*), a United States corporation owning at least 10% of the stock of a foreign corporation from which it receives dividends is deemed, for purposes of the foreign tax credit provisions of the Code, to have paid a portion of the foreign taxes actually paid by the foreign corporation. Such foreign taxes paid by the foreign corporation give rise to a "deemed paid" or "indirect" foreign tax credit. Under

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[12] This Court's treatment of the dividends from appellant's English subsidiary also should govern the treatment of appellant's foreign exchange gain from hedging those dividends. The dividends

section 78 of the Code, the United States corporation must treat the amount of the deemed paid credit as additional "gross-up" income for federal tax computation purposes.[13] However, for the reasons set forth below, there is no constitutional basis for including this gross-up amount in a resident corporation's apportionable income for state tax purposes, as New Mexico has done in this case.

The purpose of the foreign tax credit is to eliminate international double taxation by ensuring that a United States taxpayer's combined federal and foreign tax liability with respect to foreign-source income will never exceed the amount of that income multiplied by the federal or foreign tax rate, whichever is higher. Thus, in theory, the taxpayer's combined federal and foreign tax liability should always be at least equal to the amount of foreign-source income multiplied by the federal tax rate. However, prior to 1962, United States corporate taxpayers receiving dividends from foreign subsidiaries and claiming a deemed paid foreign tax credit were able, in some instances, to compute their federal tax in a way that produced a combined federal and foreign tax liability which was *less* than the amount of foreign earnings multiplied by the federal tax rate. See E. Owens and G. Ball, *The Indirect Credit* (1975), pp. 3, 57-65.

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were declared in British pounds. The hedging transactions were entered into in order to protect the dollar value of the dividends when declared, not as an independent, speculative investment. Thus, the presence of a foreign exchange gain or loss was inevitably tied to the dollar value of the dividends when received. If the dividends were worth more in dollars when received than they were when declared, appellant's hedging transaction would result in a foreign exchange loss, and *vice versa*. (See J.A. 52a-54a) This being the case, it follows that the foreign exchange gain involved here should be excluded from apportionable business income for precisely the same reasons that appellant's English dividend income should be excluded.

[13] See n. 4, p. 6, *supra*, for an example showing the calculation of the deemed paid credit and gross-up.

In order to prevent this result in the future, Congress in 1962 revised section 902(a) of the Code and enacted section 78. The Committee Reports accompanying that legislation explicitly state that the objective of these changes was to increase the United States parent corporation's effective overall tax rate on the income derived from its foreign subsidiary in those instances in which the parent corporation claimed deemed paid foreign tax credits. Thus, as part of the overall deemed paid foreign tax credit calculation, the parent corporation was required by section 78 to include the amount of the deemed paid taxes in federal taxable income as a "grossed-up" dividend. See H.R. Rep. No. 1447, 87th Cong., 2d Sess. 50-53 (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. 66-71 (1962); H.R. Rep. No. 2508, 87th Cong., 2d Sess. 27 (1962).

Because the federal tax rate for fiscal 1977 was 48% (see J.A. 63a, line 8), every $100 of deemed paid credit claimed by appellant on its federal tax return for that year produced a net reduction in federal tax of $52, computed as follows:

Deemed paid credit for foreign taxes	$100
Less: tax on $100 of gross-up at 48%	48
Net tax credit	$ 52

Although the net federal tax benefit, taking into account both parts of the calculation, was only $52 for every $100 of deemed paid credit, New Mexico claims that it is entitled to include the full $100 of gross-up in appellant's apportionable business income. There is no constitutional justification for such a result.

First, and most fundamentally, the section 78 gross-up is not income in any traditional sense of the word. It was not received by appellant for its separate "use, benefit, and disposal." *Eisner* v. *Macomber*, 252 U.S. 189, 207 (1920). Nor was the gross-up an "accession . . . to wealth, clearly realized, and over which [appellant had] complete

dominion." *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). As the New Mexico Supreme Court recognized, gross-up is a "fictional amount representing dividends 'deemed to have been received.'"[14] (J.S.App.A 3a)

Section 78 of the Code provides that the gross-up amount shall be "treated" as a dividend in those instances in which the recipient corporation claims a foreign tax credit. Obviously, if the gross-up truly constituted an item of income under the comprehensive definition of "gross income" in section 61 of the Code, as expansively interpreted by this Court in cases like *Commissioner* v. *Glenshaw Glass Co., supra,* it would have been unnecessary to enact section 78 in order to achieve income "treatment." As explained above, section 78 is nothing more than one part of a computational formula which is used to produce the correct amount of residual federal tax on foreign-source dividends received by a United States corporation which claims foreign tax credits; section 78 gross-up does not, separate and apart from the foreign tax credit mechanism which creates it, truly reflect income in any meaningful way. Thus, if the taxpayer decides to deduct rather than credit foreign taxes for federal tax purposes, the gross-up amount never comes into existence and *nothing* is added to the taxpayer's regular taxable income.

In view of the foregoing, the New Mexico Supreme Court was clearly correct when it recognized that the section 78 gross-up (J.S.App.A 5a) "does not fit the ordinary definition of 'income.'" Nonetheless, relying upon (1) the "power [of a State] to gauge its income tax by reference

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[14] The New Mexico Supreme Court also referred to gross-up as the "fictitious gross-up." (J.S.App.A 5a) Similarly, in *Dow Chemical Co.* v. *Commissioner of Rev.*, 378 Mass. 254, 391 N.E.2d 253 (1979), the Massachusetts Supreme Judicial Court stated (391 N.E.2d at 265):

> The gross-up foreign tax credit symbiosis is a means of calculating a suitable Federal tax credit for the United States parent and in truth it is a strain to deal with any part of it as 'income' for state purposes.

to the income on which the taxpayer is required to pay a tax to the United States," and (2) the asserted economic benefit that appellant obtained by reducing its federal tax liability through "the gross-up procedure" (J.S.App.A 5a-6a), the New Mexico Supreme Court upheld the inclusion of the gross-up in appellant's apportionable business income.

Appellant recognizes that a nondomiciliary State is entitled, as a general rule, to use a resident corporation's federal taxable income in determining the corporation's apportionable business income.[15] But, as the New Mexico statute here in issue specifically provides, federal taxable income must be "adjusted to exclude . . . amounts that the state is prohibited from taxing because of the laws or constitution of . . . the United States." (J.S.App.D 45a) Section 78 gross-up is such an amount. The inclusion of this admittedly "fictional amount" (J.S.App.A 3a) in apportionable business income at the state level, when the other part of the federal mechanism (*i.e.*, the foreign tax credit) is disregarded by the State, is manifestly unfair. It contravenes the Due Process Clause by apportioning to the nondomiciliary State an amount which has no "nexus" with the State or any "rational relationship" to "intrastate values." *Mobil*, 445 U.S. at 437. See also *Norfolk & Western Ry. Co.* v. *Missouri State Tax Commission*, 390

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[15] Appellant also recognizes that the taxing State's use of federal taxable income may change the year in which the income would ordinarily be reported, because in some instances the Internal Revenue Code has special rules for certain types of income. See, *e.g.*, *Dow Chemical Co.* v. *Commissioner of Rev.*, *supra* (State followed federal treatment of subpart F income), *Champion International Corp.* v. *Bureau of Revenue*, 88 N.M. 411, 540 P.2d 1300 (Ct. App. 1975) (State followed federal treatment of income from cutting timber), and *Garlin* v. *Murphy*, 51 Misc.2d 477, 273 N.Y.S.2d 374 (1966), *aff'd*, 34 N.Y.2d 921, 359 N.Y.S.2d 552 (1974) (State followed federal treatment of a shareholder of a subchapter S corporation).

U.S. 317 (1968); *Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931).

Nor can appellant's federal tax benefit from its foreign tax credit election afford New Mexico any basis for taxing the section 78 gross-up. First, appellant's federal tax liability is irrelevant to the computation of New Mexico's apportionable business income which is determined without any adjustment or modification whatsoever for federal taxes. Certainly, New Mexico has not suggested that appellant could *decrease* its apportionable business income by the amount of its federal taxes. That being the case, it is anomalous for the State to suggest that apportionable business income should *increase* because of a savings in federal taxes.

Essentially the same suggestion was rejected by this Court in *Hort* v. *Commissioner*, 313 U.S. 28 (1941). In *Hort*, the taxpayer-lessor sought a deduction for lost rent as a consequence of a lease cancellation. This Court held that, for federal tax purposes, the taxpayer's lost revenues would be adequately accounted for by the fact that they would never be included in gross income; the taxpayer could not obtain a double benefit by taking a deduction against other income for the lost revenues that he had not included in income in the first place. Similarly, in this case, New Mexico cannot require appellant to include a federal tax savings in income when its federal tax liability was never deducted. Such a result is constitutionally prohibited by the Due Process Clause because it is "inherently arbitrary." *Underwood Typewriter Co.* v. *Chamberlain, supra*, 254 U.S. at 121.

As discussed above, the benefit of a taxpayer's foreign tax credit election was *reduced* in 1962 by the addition of section 78 of the Code. Yet, for years prior to 1962, New Mexico never sought to adjust a taxpayer's apportionable business income because of the taxpayer's federal foreign tax credit election. Now, as a consequence of section 78 (which has the effect of *reducing* the benefit of the foreign tax credit election), New Mexico takes the illogical position

that appellant's apportionable business income was somehow *increased.*[16]

In reaching its decision, the New Mexico Supreme Court relied on the Vermont decision in *F. W. Woolworth Co.* v. *Commissioner of Taxes,* 130 Vt. 544, 298 A.2d 839 (1972). That decision has since been overruled.[17]

Finally, even if all of the foregoing considerations were set aside and the gross-up could properly be viewed as income for state tax purposes, it would not follow that it constituted apportionable business income. We have previously shown that the dividends actually paid by the subsidiaries to appellant are not properly apportionable. *A*

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[16] In its Motion to Dismiss, appellee asserts (p. 11) that—

> The record shows that Woolworth was relieved of $25,502,782 of federal taxes which otherwise would have been due and payable by Woolworth, by virtue of being allowed to claim, as its own, foreign taxes which were actually paid by another person. In short, Woolworth pocketed $25,502,782 which it otherwise would not have had.

It is ironic, to say the least, that appellee fails to take into account appellant's federal tax payment on the very item of gross-up which appellee is seeking to treat as income here. As shown by the example on p. 27, *supra,* the net federal tax reduction which resulted from appellant's foreign tax credit election was only 52% of the $25,502,782 deemed paid credit.

[17] See *In re Appeal of Norris Knosher,* 139 Vt. 285, 428 A.2d 1104 (1981). Nor, insofar as the constitutional issue presented here is concerned, is there any other support for the result below. In *Dow Chemical Co.* v. *Commissioner of Rev., supra,* for example, Dow's taxable income was not increased by the gross-up since the gross-up was deducted under the Massachusetts statute. Thus, as the Massachusetts Supreme Judicial Court explicitly recognized (391 N.E.2d at 256-257), the constitutional issues were not reached. Similarly, in *Caterpillar Tractor Co.* v. *Lenckos,* 84 Ill.2d 102, 417 N.E.2d 1343 (1981), *prob. juris. noted sub nom., Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co., Illinois Department of Revenue et al.,* —— U.S. ——, No. 81-349, no constitutional issue was raised with respect to gross-up.

fortiori, the foreign tax payments which are "treated" as a grossed-up dividend for federal tax computation purposes are not apportionable. To repeat, the gross-up amount had *no* connection of any kind with any New Mexico activities.

III. ALTERNATIVELY, EVEN IF SOME PORTION OF THE DIVIDENDS, EXCHANGE GAIN, AND GROSS-UP MAY CONSTITUTIONALLY BE INCLUDED IN APPELLANT'S APPORTIONABLE BUSINESS INCOME, BOTH THE DUE PROCESS CLAUSE AND THE FOREIGN COMMERCE CLAUSE WILL BE VIOLATED UNLESS A CORRELATIVE ADJUSTMENT IS MADE TO NEW MEXICO'S APPORTIONMENT FACTORS.

A. The Due Process Clause.

The only Due Process Clause issue considered in *Mobil* was whether Mobil's dividend income from subsidiaries and affiliates could be included in Mobil's apportionable income. Because Mobil did not present the question, the Court expressly refrained from deciding whether the inclusion of such dividends in apportionable income would necessitate some correlative adjustment to Vermont's apportionment factors. See 445 U.S. at 434, 441, n. 15, and 449.

We have previously contended that, under the Due Process Clause, the dividends, exchange gain, and gross-up may not be included in appellant's apportionable business income. If, however, the Court holds that any of those items may be included in appellant's apportionable income, correlative adjustments to New Mexico's apportionment factors will be required to satisfy the requirements of the Due Process Clause. Unless the apportionment factors are adjusted, the method used by New Mexico will be "inherently arbitrary." See *Underwood Typewriter Co.* v. *Chamberlain, supra*, 254 U.S. at 121; *Bass, Ratcliff & Gretton* v. *State Tax Commission, supra*, 266 U.S. at 282-283.

Although the Court did not reach the issue in *Mobil*, Mr. Justice Stevens stated in his dissent (445 U.S. at 461):

> Unless the sales, payroll and property values connected with the production of income by the [dividend] payor

> corporations are added to the denominator of the apportionment formula, the inclusion of earnings attributable to those corporations in the apportionable tax base will *inevitably* cause Mobil's Vermont income to be overstated. [Footnote deleted; emphasis supplied.]

The reason for Mr. Justice Stevens' conclusion is clear. New Mexico, as a nondomiciliary State, can tax appellant only on that portion of its income which is attributable to appellant's activities in New Mexico. In determining that amount, it should make no difference whether appellant's Unitary Business (whose income is being apportioned for this purpose) is conducted through divisions or separately incorporated subsidiaries. As this Court stated in *Mobil* (445 U.S. at 440-441):

> Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability. Cf. *General Motors Corp.* v. *Washington*, 377 U.S. 436, 441 (1964). *Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives.* [Footnote deleted; emphasis supplied.]

Thus, if the total amount of apportionable income in the parent-subsidiary case remains the same as it is where the parent operates through divisions, it follows that the share or percentage of that income properly apportionable to the taxing State also ought to remain the same. After all, the value of the activities carried on in the taxing State is not affected by the taxpayer's corporate structure any more than is the amount of the taxpayer's apportionable income.

However, the results of operating a unitary business through a subsidiary will *not* be the same as the results of operating through a division unless the apportionment formula is appropriately adjusted when dividends paid by the

subsidiary are included in the taxpayer's apportionable income. This can be demonstrated by assuming that the taxpayer conducts a unitary business through two divisions (Division A, which operates both inside and outside New Mexico, and Division B, which operates entirely outside New Mexico). Assume the following figures:

	Division A		Division B	
	All Locations	New Mexico Situs	All Locations	New Mexico Situs
Property	$200,000	$20,000	$100,000	-0-
Payroll	300,000	30,000	150,000	-0-
Sales	400,000	40,000	200,000	-0-
Business Income	50,000		10,000	

On these facts, the income apportioned to New Mexico will be $4,000, computed as follows:

Total Business Income = $50,000 + $10,000 = $60,000

New Mexico Factors:

$$\left[\frac{\text{Property}}{\frac{20{,}000}{300{,}000}} + \frac{\text{Payroll}}{\frac{30{,}000}{450{,}000}} + \frac{\text{Sales}}{\frac{40{,}000}{600{,}000}}\right] \div 3 = \frac{1}{15}$$

$$\text{New Mexico Taxable Income} = \$60{,}000 \times \frac{1}{15} = \$4{,}000$$

However, if the business of Division B is operated through a wholly owned subsidiary corporation, and all income of the subsidiary is distributed as a dividend to the parent and included in apportionable business income, the results will be markedly different if there is no adjustment in the parent's apportionment factors. Under these circumstances, the income apportioned to New Mexico will be increased by 50% to $6,000, computed as follows:

Parent's Business Income = $50,000 + $10,000 = $60,000

Parent's New Mexico Factors:

$$\left[\frac{\text{Property } 20{,}000}{200{,}000} + \frac{\text{Payroll } 30{,}000}{300{,}000} + \frac{\text{Sales } 40{,}000}{400{,}000} \right] \div 3 = \frac{1}{10}$$

$$\text{New Mexico Taxable Income} = \$60{,}000 \times \frac{1}{10} = \$6{,}000$$

The New Mexico Supreme Court held that inclusion of $66,979,494 of dividends, exchange gain, and gross-up in appellant's apportionable business income did not require any adjustment to the apportionment factors other than the Revenue Department's inclusion of the disputed items in the denominator of appellant's sales fraction. In rejecting appellant's claim that this adjustment to the sales fraction was insufficient, the New Mexico Supreme Court asserted that appellant had:

> . . . offered no evidence upon which further adjustments could be predicated. The Department found that Woolworth failed to present 'a reasonable and specific proposal' for further adjustments to Woolworth's payroll, sales and property factors and denied further modification to the formula. [J.S.App.A 20a-21a]

In fact, appellant specifically proposed to the Revenue Department that appellant's property, payroll, and sales factors should be adjusted to reflect the property, payroll, and sales of the foreign subsidiaries.[18] The Revenue De-

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[18] Appellant also showed that the inclusion of the gross-up would, by itself, increase apportionable business income from $18,274,068, as initially reported, to $43,776,850. (J.A. 57a, line 22; J.A. 61a, Sch. C, line 7) In comparable circumstances, the Vermont Supreme Court held in *F. W. Woolworth Co.* v. *Commissioner of Taxes*, 130 Vt. 544, 298 A.2d 839, 835 (1972), that Woolworth's evidentiary burden had been satisfied because the "obvious effect" of including gross-up in apportionable income without adjusting the apportionment factors was to overstate the income taxable in Vermont. The New Mexico Supreme Court ignored this portion of the Vermont decision, but relied heavily on another portion of that

partment rejected this proposal on the merits (not for failure of proof), stating (J.S.App.A 37a):

> 21. Taxpayer argues that the Department must use the three factors of the foreign subsidiaries but it fails to suggest that the Department might then also take into account the net income of the foreign subsidiaries. In fact, however, the Department is not attempting to impose a tax on the net income of the foreign subsidiaries; the New Mexico tax is on the business income of the taxpayer and the taxpayer fails to show how the foreign subsidiaries' factors relate to this taxpayer's business income. [Footnote deleted.]
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> 22. In its brief, the taxpayer 'petitions' for a modification of the statutory three factor formula. Assuming *arguendo* that this petition is timely, the taxpayer has not presented a reasonable and specific proposal which would meet the requirements of § 72-15A-34.

It is now clear, however, from this Court's opinion in *Mobil*, that appellant's proposal should have been accepted. In a case like this, the inclusion of dividends in apportionable business income depends on the underlying activities of the dividend-paying corporations—activities clearly carried on outside New Mexico—and not on appellant's own activities. Thus, if the dividends and the related exchange gain and gross-up are to be included in the apportionable income base (as part of the procedure for determining what may constitutionally be taxed in New Mexico), the apportionment factors must be correlatively reduced to reflect the property, payroll, and sales of the subsidiaries whose businesses generated that income. Only in that way will the result be the same as it would have been if the businesses conducted by those subsidiaries had been conducted directly in divisions of appellant. As the above example demonstrates, failure to reduce the apportionment fractions results in a *gross* overstatement of the portion of the unitary business income which is properly attributable to the taxing State and *penalizes* the taxpayer for operating through a subsidiary rather than a division.

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decision which has since been overruled. (See J.S.App.A 5a-6a and n. 17, p. 31, *supra*)

Indeed, as recently conceded by the Executive Director of the Multistate Tax Commission (the "MTC"), failure to adjust the apportionment factors in a case like the present one "produces a still higher tax result for the State" than combined reporting does.[19] This Court recently noted probable jurisdiction in a case challenging the constitutionality of combined reporting as applied to foreign subsidiaries and affiliates.[20] While we agree with the position taken by the appellant in that case, it is not necessary to reach the issues raised there to sustain appellant's position here. The MTC's admission that the decision below produces a "still higher tax result for the State" than does combined reporting is a direct acknowledgment that inclusion of dividends in the recipient's apportionable income without an adjustment in the apportionment factors results in a conceptually indefensible overstatement of the income attributable to the taxing State. As demonstrated above, the State is certainly attempting to collect a "higher tax" from appellant than it could ever hope to collect if appellant's subsidiaries were unincorporated divisions.[21] Penal-

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[19] See Corrigan, *Mobil-izing Interstate Taxation*, Tax Notes, Vol. XIII, No. 15, Oct. 12, 1981, p. 808 (comparing Cases B and E to Case C, which is comparable to the present case).

[20] *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co., Illinois Department of Revenue et al., supra.* See also *Container Corporation of America* v. *Franchise Tax Board*, 117 Cal.App.3d 988, 173 Cal. Rptr. 121 (1981), appeal docketed, No. 81-523.

[21] In this case, the disputed additions to appellant's apportionable business income for fiscal 1977 totaled $66,979,494 (consisting of $65,383,943 of dividends and gross-up, and $1,595,551 of exchange gain). (J.A. 69a) However, *none* of the property, payroll, or sales of the dividend-paying subsidiaries were taken into account by the Revenue Department. The only token gesture made by the Department was to increase the denominator of the sales fraction by the amount added to apportionable income. As a result, the apportionment factor was reduced by .004738 of 1%. (See n.5, p.7, *supra.*) This *de minimis* adjustment was plainly inadequate to

izing appellant in this fashion is patently arbitrary and an unconstitutional violation of due process. *Norfolk & Western Ry. Co.* v. *Missouri State Tax Commission, supra; Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell, supra; Underwood Typewriter Co.* v. *Chamberlain, supra; People ex rel. Alpha Portland Cement Co.* v. *Knapp,* 230 N.Y. 48, 129 N.E. 202 (1920). Appellee has ignored this Court's holding in *Mobil* (445 U.S. at 441) that transforming divisional profits of a unitary business into dividends "works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives."

The issue is not, as the Revenue Department would have it, whether dividends *per se* are the income of the recipient or are paid out of the income of the payor. The real issue is whether the apportionment formula fairly employs, on a consistently applied basis, factors which reflect " 'the relative contribution of the activities in the various states to the production of the total unitary income.' " *Butler Bros.* v. *McColgan, supra,* 315 U.S. at 509. Under formulary apportionment, the total income of the unitary business must be ratably divided (on the basis of the apportionment factors employed) between the taxing State and all other jurisdictions in which the unitary business is conducted, so that the taxing State receives the same "rate of return" as is earned by the entire business collectively. Thus, where the traditional three-factor apportionment formula is properly employed, the taxing State should receive the same amount of income for every dollar of property, payroll, and sales in the State as the entire unitary business earns for every dollar of total property, payroll, and sales in all

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reflect the subsidiaries' underlying property, payroll, and sales which (1) produced the additional income, and (2) would have been taken into account had the businesses been run as unitary divisions of appellant rather than being run by separate subsidiaries.

locations. This concept *cannot possibly work*, however, if a State which uses the three-factor formula overloads its own "rate of return," as New Mexico has done here, by giving full weight to property, payroll, and sales in the State, but only token weight to sales outside the State, and no weight *at all* to property and payroll outside the State. By ignoring out-of-state property and activities, New Mexico has unfairly increased the weight given to property and activities within the State. By so doing, it seeks to increase its "rate of return" (*i.e.*, the income it earns for every dollar of local property, payroll, and sales) to a rate *higher* than the average rate applicable to the unitary business as a whole. This is so alien to the whole concept of "unitary" apportionment that it is a *per se* violation of the Due Process Clause.

This view of the conceptual relationship between apportionable business income and the apportionment factors is hardly new or novel. In addition to Mr. Justice Stevens' recognition of this relationship in his dissent in *Mobil*, see also *People ex rel. Alpha Portland Cement Co.* v. *Knapp*, *supra*, and *Household Finance Corp.* v. *State Tax Commission*, 212 Md. 80, 128 A.2d 640, 649 (1957). Cf. *F. W. Woolworth Co.* v. *Commissioner of Taxes*, 130 Vt. 544, 298 A.2d 839 (1972). In the *Alpha Portland Cement* case, as here, investment income was included in apportionable income without adjusting the apportionment factor to reflect the out-of-state assets which generated the income. The court, in an opinion by Judge Cardozo, invalidated the statutory scheme, stating (129 N.E. at 204, 206):

> The interest enters into the income on which the tax has been computed; the principal has been excluded in the allocation of the assets.
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> • • •
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> Dividends from other shares, those of the Anvil Stone Company, are included in the income; the shares themselves do not enter into the terms of the proportion.
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> • • •

> [T]he statute prescribes a rule of allocation which, as applied to foreign corporations holding bonds and shares in other states, involves an artificial and arbitrary augmentation of the value of the local privilege. It measures the value of the franchise, here and elsewhere, by income from all sources, and excludes some of the same sources when the value is apportioned. *To take from assets elsewhere is equivalent to adding to assets here.*
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> * * *
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> [A] method of apportionment which purposely ignores realities, which compels an assessor to look to some of the assets only, and close his eyes to all the others, is arbitrary and unreasonable in its increase of the local burden. [Emphasis supplied.]

Similarly, New Mexico should not be permitted to add to the income-producing value of the property, payroll, and sales in New Mexico by ignoring a substantial portion of the income-producing property, payroll, and sales outside the State. If some portion of the dividends, gross-up, or exchange gain in issue here is to be included in appellant's apportionable business income, due process requires that the apportionment factors be modified in a way which will meaningfully and fairly reflect the foreign property, payroll, and sales which generated that income.

With respect to dividends, we believe, as proposed below, that this can ordinarily best be done by increasing the denominators of the property, payroll, and sales fractions by an appropriate percentage of the property, payroll, and sales of the corporations paying the dividends. The appropriate percentage, in each case, could be determined by comparing the dividends received by appellant from a particular corporation with that corporation's earnings for that year. For example, if appellant owned 50% of a corporation's stock and the corporation paid out 30% of its earnings for the year as dividends, 15% (*i.e.*, 30% of 50%) of the corporation's property, payroll, and sales

for that year would be included in the denominators of appellant's apportionment fractions for that year.[22]

Appellee objects (Motion to Dismiss, p. 15) to the sufficiency of the evidence in this case, asserting that it fails to satisfy the "clear and cogent" standard of *Butler Bros.* v. *McColgan, supra,* 315 U.S. at 507, which applies when a taxpayer attempts to show that the taxing State's apportionment formula results in the taxation of "extra-territorial values." However, the dramatic, nearly five-fold increase in appellant's New Mexico taxable income from $84,662 to $401,518 (see p. 7, *supra*) more than satisfies any evidentiary burden. Moreover, as this Court pointed out in *Underwood Typewriter Co.* v. *Chamberlain, supra,* 254 U.S. at 121, an apportionment formula can be invalidated by showing that it is "inherently arbitrary." In view of the demonstrated conceptual relationship between the apportionment base and the apportionment factors, New Mexico's failure to adjust the apportionment factors will "inevitably" produce an arbitrary result if the dividends or other comparable income items are included in the apportionable income base. See *Mobil,* 445 U.S. at 461 (dissenting opinion).

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[22] The same approach was taken by the Vermont Supreme Court with respect to gross-up. See *F. W. Woolworth Co.* v. *Commissioner of Taxes,* 133 Vt. 93, 328 A.2d 402 (1974). It would be equally appropriate to use this approach if appellant's exchange gain were included in apportionable income. Since the amount of exchange gain or loss depended entirely on the value of the dividend appellant received from its English subsidiary (J.A. 52a-54a), the gain could logically be treated as additional dividend income. In any event, if it becomes necessary to modify the apportionment factors in this case, we suggest that this be done, in the first instance, by the Revenue Department on remand, in the light of the specific facts of the case. Of course, appellant reserves the right to challenge the constitutionality of any modified apportionment formula adopted by the Revenue Department if that formula, as applied to appellant, results in a denial of due process as defined by this Court's decisions.

B. The Foreign Commerce Clause.

Mobil also involved the application of the Commerce Clause, but the decision there is not dispositive of the Foreign Commerce Clause issue presented here. In *Mobil*, the taxpayer argued that Vermont's tax imposed a burden on interstate and foreign commerce by subjecting Mobil's dividend income to a substantial risk of multiple state taxation. Mobil premised that multiple taxation argument on the assumption that all of its dividend income was fully taxable in the State of commercial domicile (New York, in its case) and, therefore, any apportionment to Vermont unavoidably subjected Mobil to the risk of multiple state taxation.

This Court rejected Mobil's argument, both with respect to an alleged burden on interstate commerce and with respect to foreign commerce. With respect to Mobil's foreign commerce argument, this Court stated (445 U.S. at 446-447):

> . . . Mobil suggests that dividends from foreign sources must be allocated to the State of commercial domicile, even if dividends from subsidiaries and affiliates operating domestically are not. By accepting the power of the State of commercial domicile to tax foreign-source dividend income, appellant eschews the broad proposition that foreign-source dividends are immune from state taxation. It presses the narrower contention that, because of the risk of multiple taxation abroad, allocation of foreign-source income to a single situs is required at home.
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> * * *
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> By admitting the power of the State of commercial domicile to tax foreign-source dividends *in full*, Mobil necessarily forgoes any contention that local duplication of foreign taxes is proscribed. Thus, the only inquiry of constitutional dimension is the familiar question whether taxation by apportionment at home produces significantly greater tax burdens than taxation by allocation. Once appellant's argument is placed in

this perspective, the presence or absence of taxation abroad diminishes in importance.

Appellant now asserts the Foreign Commerce Clause argument which Mobil refrained from making—namely, that *any* "local duplication of foreign taxes is proscribed."

As a general rule, *interstate* commerce is not exempt from state taxation provided the state tax in issue is applied to an activity having a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State. *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, 279 (1977); *Washington Rev. Dept.* v. *Stevedoring Assn.*, 435 U.S. 734, 750 (1978). But when a State seeks to tax *foreign* commerce, two additional questions must be considered: "[f]irst, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.' " *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 451 (1979) (hereinafter "*Japan Line*"). "If a state tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause." *Ibid.* New Mexico's tax contravenes both precepts.

1. *The Substantial Risk of Double Taxation:* There is worldwide recognition of the principle that the source nation (*i.e.*, the nation where income originates) has the primary right to tax the gross amount of dividends, interest, royalties, and other similar items of income paid by a resident of the source nation to a nonresident.[23] In accordance with that "custom of nations" (*Japan Line*, 441 U.S. at 447, 454), Canada, England, Germany, and Mexico all impose an income withholding tax on the full amount of dividends paid by resident companies to nonresident shareholders

[23] See the articles cited in nn. 29 and 30, *infra*.

ers.[24] Under these laws, as limited by applicable income tax conventions, appellant was subject in fiscal 1977 to withholding taxes equal to 15% of the full amount of its Canadian dividend, 15% of its German dividend, and 21% of its Mexican dividend.[25] As the Hearing Examiner of the Revenue Department found, appellant's foreign subsidiaries paid the foreign withholding taxes required to satisfy appellant's tax obligations with respect to the dividends it received. (J.S.App.A 31a-32a) Thus, allowing New Mexico to tax the same dividends "creates more than the *risk* of multiple taxation; it produces multiple taxation in fact." *Japan Line,* 441 U.S. at 452.

In *Japan Line,* the question was whether local governmental units in California could impose property taxes on

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[24] See the Canadian, German, and Mexican statutory provisions reproduced in App. A, *infra.* These laws clearly provide that the foreign withholding taxes are imposed on the nonresident recipient of the dividend payment. Although the tax is remitted to the foreign government by the foreign payor of the dividend, the payor is simply acting as a withholding agent for the recipient. Thus, it is clear that the taxpayer subject to foreign tax on the dividends from the Canadian, German, and Mexican subsidiaries was appellant—not the foreign subsidiaries. (See also J.A. 31a) Although appellant itself was not directly subject to United Kingdom tax in fiscal 1977 on the dividends it received during that year from its English subsidiary, appellant was subject to a 5% United Kingdom tax in 1980 with respect to those dividends as a result of the retroactive application of Article 10 of the Income Tax Convention between the United Kingdom and the United States, Dec. 31, 1975, —— U.S.T. ——, T.I.A.S. No. 9682. For an explanation of the United Kingdom tax structure as modified by the Convention, see Rev. Proc. 80-18, 1980-1 C.B. 623.

[25] The rates of tax specified in the statutory provisions referred to in n. 24, *supra,* were limited to the rates specified in the text by Article XI(1) of the Income Tax Convention between Canada and the United States, June 12, 1950, 2 U.S.T. 2235, T.I.A.S. No. 2347; and Article VI(2) of the Income Tax Convention between Germany and the United States, as amended, Sept. 17, 1965, 16 U.S.T. 1875, T.I.A.S. No. 5920.

cargo containers that were subject to tax in Japan. Because Japan taxed the full value of the containers, this Court held that *any* additional state tax, regardless of how that tax was apportioned, would inevitably produce double taxation in contravention of the Foreign Commerce Clause.

We recognize that a different situation may be presented in the case of income taxes. The theory of apportionment, as applied in an income tax context, is that the taxing State is not taxing any out-of-state income as such, but is simply using the out-of-state income, and the out-of-state property, payroll, and sales factors, as a means of more accurately calculating the portion of the total income which is fairly attributable to the activities in the taxing State. Thus, if foreign-source income items which have been taxed abroad are included in the apportionable income base, it is conceivable that multiple income taxation by the State could be avoided by a correlative decrease in the apportionment factors to reflect the foreign property, payroll, and sales associated with that income.[26] We have previously argued that such an adjustment to the apportionment factors is required by the Due Process Clause. However, if the Court holds that the Due Process Clause does not require New

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[26] Since such an adjustment to the apportionment factors would decrease the percentage of the other apportionable income that would otherwise be taxed by the nondomiciliary State, the adjustment could theoretically offset the effect of imposing a second tax on a portion of the foreign-source income.

There are, however, powerful arguments which can be made to support the conclusion that unitary apportionment of foreign-source income in this fashion is not constitutionally acceptable in practice, even if theoretically appropriate apportionment factors are used. See the Jurisdictional Statements filed in *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co., Illinois Department of Revenue et al., supra,* and *Container Corporation of America* v. *Franchise Tax Board, supra.* We need not now reach that issue in this case, since it is clear that New Mexico has made no meaningful adjustment to its regular apportionment factors, with the result that a double tax is being asserted. If this case is remanded for

Mexico to make a correlative adjustment to the apportionment factors, New Mexico would then be taxing a portion of the foreign dividends and gross-up *in addition to* its full share of the other apportionable business income. Under these circumstances, it *unavoidably* follows that the dividends and gross-up would be subject to multiple taxation—full taxation by the source nation and partial taxation by New Mexico. Such a result cannot be squared with *Japan Line.*

2. *Federal Government Policy:* The remaining consideration that must be taken into account under *Japan Line* is whether the asserted state tax may "impair federal uniformity" by preventing the Federal Government from "'speaking with one voice when regulating commercial relations with foreign governments.'" *Japan Line,* 441 U.S. at 448, 451.

Since the enactment of sections 222 and 238 of the Revenue Act of 1918, ch. 18, 40 Stat. 1057, the revenue laws of the United States have been premised on the principle that the jurisdiction where income is generated has the primary right to tax that income, with the result that United States taxpayers should be allowed to reduce their regular federal tax liability by the amount of foreign income tax paid on their foreign-source income.[27] Surrey, *Current Issues in the Taxation of Corporate Foreign Investment,* 56 Colum. L. Rev. 815, 817 (1956); E. Owens, *The Foreign Tax Credit*

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the purpose of permitting the State to modify the apportionment factors, appellant reserves the right to challenge the constitutionality of the modified apportionment formula if, in light of the facts and this Court's decisions, the formula as applied to appellant still results in the effective imposition of a state tax on foreign-source income which has already been taxed abroad.

[27] The foreign tax credit provisions were originally adopted in the Revenue Act of 1918 in order to relieve a "very severe burden" imposed as the result of multiple taxation. H.R. Rep. No. 767, 65th Cong., 2d Sess. (1918) (1939-1 C.B. (Pt. 2) 86, 93). See *Burnet* v. *Chicago Portrait Co.,* 285 U.S. 1, 7 (1932).

(1961), pp. 2-3, 590-591. The United States has also sought to reduce the risk of double taxation of dividends through tax treaties which assure that the recipient's country will allow a credit or offset for taxes paid to the source country.[28] The position taken by the United States in its treaties is in accordance with model international tax conventions which have recognized the primary right of the source nation to impose a tax on corporate dividends, with the nation where the shareholder resides having a concomitant responsibility to reduce its regular tax on that dividend income by an equivalent amount. See Article 10, Article 23A, and Article 23B of the Draft Double Taxation Convention on Income and Capital (1963) adopted by the Organization for Economic Co-Operation and Development (the "OECD").[29]

It is obvious, we think, that the United States can speak with "one voice" in regulating foreign commerce only if the States and political subdivisions that choose to tax income from foreign commerce are required to recognize and implement the basic policies which the Federal Government applies in taxing such income. The avoidance of double taxation of foreign-source income is such a policy. Moreover, the Federal Government's policy in this area is clearly in accord with the "custom of nations." See *Japan*

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[28] Provisions to this effect are included in 27 ratified conventions and 13 pending conventions between the United States and various foreign countries. These conventions are listed in App. C, *infra*.

[29] The United States Department of Treasury has adopted the OECD model convention as its basic negotiating position in bilateral income tax treaty negotiations. 46 Fed. Reg. 37432 (July 20, 1981). For a discussion of comparable concepts previously developed by the Fiscal Committee of the League of Nations in its model convention, see Ke Chin Wang, *International Double Taxation of Income: Relief Through International Agreement 1921-1945*, 59 Harv. L. Rev. 73, 81-97 (1945).

Line, 441 U.S. at 447, 454. Virtually every developed non-communist country in the world has an income tax structure which is designed to avoid double taxation of international income by effectively giving taxing priority to the source nation.[30]

Because this policy is firmly embedded in federal law and treaties, and clearly constitutes the custom of nations, we think it is constitutionally intolerable for the States to disregard it. Put differently, we believe that any State choosing to include foreign-source income in its apportionable tax base has a constitutional obligation to devise some mechanism which will effectively prevent the imposition of a second tax on any income that has already been taxed abroad by the source nation.[31]

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[30] This is generally done either by excluding the foreign-source income from the tax base altogether, or by taxing it and then allowing a credit for the tax imposed by the source nation. See Dr. D. Juch, "General Report on Unilateral Measures to Prevent Double Taxation," *Cahiers de Droit Fiscal International*, Vol. LXVI b, International Fiscal Association, XXXV Congress, Berlin (1981) and the more detailed national reports which follow in the same volume.

[31] The fact that bills regulating state taxation of foreign income have been introduced in Congress, but not enacted, should not prevent this Court from requiring the States to act in a manner consistent with long-standing, consistently implemented federal policy. Congressional failure to act should not be viewed as tacit approval of current state practices where, as here, it can be shown that those practices are fundamentally at odds with the Federal Government's taxing policy with respect to foreign income as evidenced by laws which Congress *has* enacted and treaties which the Senate *has* ratified. State action which imposes a clear burden on foreign commerce by subjecting foreign income to double tax is contrary to the Foreign Commerce Clause and should therefore be prohibited by this Court until and unless Congress takes affirmative action to sanction it.

In *Mobil*, this Court stated (445 U.S. at 448) that "[a]bsent some explicit directive from Congress, we cannot infer that treat-

New Mexico's taxing statute does not comport with federal policy, either in concept or in practice. New Mexico makes no effort to reflect, in any way, the foreign withholding taxes imposed on foreign-source dividends, interest, royalties, or other similar income items received by New Mexico residents. Thus, if appellant's Canadian subsidiary declares a $100 dividend to appellant, withholds the $15 of Canadian tax which appellant owes, and remits the remaining $85 to appellant, New Mexico will include the full $100 in appellant's apportionable business income. Moreover, New Mexico will tax a portion of that amount without allowing any credit or other offset for the $15 Canadian withholding tax borne by appellant on the same income, and without making any meaningful adjustment to the regular New Mexico apportionment factors.

This Court cannot prevent Canada and other foreign countries from continuing to tax appellant on 100% of the dividends it receives from those countries. See *Japan Line*, 441 U.S. at 447-448. Accordingly, inclusion of the dividends in appellant's apportionable income for state tax purposes, without offsetting relief, inevitably means that more than 100% of the income will be taxed. The resulting

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ment of foreign income at the federal level mandates identical treatment by the States." However, this statement was clearly made in the context of a discussion which was *not* dealing with "problems of duplicative taxation at the international level" but was, instead, focusing on "the wholly different sphere of multiple taxation among our States." *Ibid.* Where, however, foreign commerce is involved, this Court has made it clear that the States are not "free to impose demonstrable burdens" on such commerce simply because Congress has not "pre-empted the field by affirmative regulation." *Japan Line*, 441 U.S. at 454. This is because:

> [I]t long has been "accepted constitutional doctrine that the commerce clause, without the aid of Congressional legislation . . . affords some protection from state legislation inimical to the national commerce, and that in such cases, where Congress has not acted, this Court, and not the state legislature, is under the commerce clause the final arbiter of the competing demands of state and national interests." [Citation deleted; *Ibid.*]

double taxation imposes an actual burden on foreign commerce which is significant now[32] and could become appreciably greater in the near-term future.[33] We urge this Court to eliminate that burden by applying the principles of *Japan Line* to state income as well as property taxes.

CONCLUSION

For the foregoing reasons, this Court should reverse the decision below and remand the case to the Supreme Court of New Mexico for further proceedings in conformity with this Court's opinion.

Respectfully submitted,

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[32] There are presently at least 27 States which apportion dividend income. See Appendix F to the Jurisdictional Statement filed in *Mobil*, a copy of which is reproduced in App. D, *infra*. In 1974, the latest year for which federal tax return statistics are available, United States corporations claiming a foreign tax credit received foreign-source dividends of over $6.1 billion. 1974 Statistics of Income, International Income and Taxes, Foreign Tax Credit (GPO, Washington, D.C. 1980), p. 9, col. 2.

[33] The earnings which United States companies have repatriated from direct foreign investments have increased five-fold in the last decade "to an estimated $41 billion for 1981." See Janssen, *Tracking a Trend*, Wall St. J., Mar. 11, 1981, p. 56. There is every reason to expect this trend to continue.